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Memorandum

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subject: Allocation of DPGR and non-DPGR when separately stated price is available.

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LEGEND

Taxpayer	=	EIN:
Subsidiary	=	
Tax Year Ending 1	=	
Tax Year Ending 2	=	
Tax Year Ending 3	=	
Software 1	=	

Software 2 =

Amount 1 =

Amount 2 =

Amount 3 =

Amount 4 =

Title 1 =

License Agreement =

Franchise Agreement =

ISSUES

1. Whether Taxpayer must use its agreements' separately stated prices to allocate gross receipts between domestic production gross receipts (*DPGR*) and non-*DPGR* under Treas. Reg. § 1.199-1(d)(1) and (2)?
2. Whether Taxpayer can allocate separately stated gross receipts for intangible property as attributable to an embedded service or nonqualified property under Treas. Reg. § 1.199-3(i)(4)(i)(A) when the regulation requires a taxpayer to allocate gross receipts between embedded non-qualified property and qualified production property (*QPP*)?
3. Whether Taxpayer may disregard its agreements' terms and allocate gross receipts received for a grant of intangible rights to a license of *QPP*?

CONCLUSIONS

1. Yes. Taxpayer must use its agreements' separately stated prices to identify what gross receipts are allocable to *DPGR* under Treas. Reg. § 1.199-1(d)(1) and (2). This information is readily available, because it is in the agreements. Taxpayer can identify which gross receipts are *DPGR* without undue burden or expense, because it already knows what it received under these agreements.
2. No. Taxpayer may not allocate gross receipts from the transaction between these two properties. The intangible rights are not embedded with the *QPP*. The taxpayer's agreements state separate prices for each property.

3. No. Taxpayer may not disregard its agreements' terms and allocate gross receipts received for a grant of intangible rights to a license of QPP.

FACTS

Taxpayer franchises Subsidiary . Taxpayer requires all franchisees to enter into two related contracts. Taxpayer's Franchise Agreement grants franchisees rights to operate a Subsidiary in exchange for a monthly royalty payment. Taxpayer's License Agreement grants software licenses to franchisees in exchange for a stated fee.

The License Agreement recognizes that it is only part of Taxpayer's arrangement with franchisees. The License Agreement's preamble states that the franchisee "has the exclusive right to operate one or more Subsidiary . . . under a Franchise Agreement" The License Agreement further states that Subsidiary "has developed and is willing to provide . . . certain proprietary software [e.g. Software 1 and Software 2] for use in operating . . ." The License Agreement further states that "[t]he parties wish to formalize their agreement with respect to the software provided to Franchisee." The License Agreement constitutes the entire agreement between Taxpayer and franchisees concerning Taxpayer license of computer software to its franchisees.

The License Agreement offers franchisees a limited license of Software 1 and Software 2. The agreement describes Software 1 as "a point of sale management solution developed for the Subsidiary's concept . . . designed to help perform various functions, such as time clock, order entry, pricing and taxing, cash management, employee maintenance, reporting and other various functions." The agreement describes Software 2 as "a software payment solution for [] to use in conjunction with [the Software 1] to authorize and settle guest checks with an electronic form of payment." Software 1 and the Software 2 are designed to work together. The license is limited. The License Agreement provides that franchisees receive a:

non-transferable and non-exclusive right and license to install, execute, use, copy, display and perform the [Software1 and Software 2] exclusively in one or more [] . . . , including any updates supplied by Taxpayer from time to time, and to receive the services [described in the license], and any related printed or electronic reference materials provided by Taxpayer.

Franchisees may install Software 1 and Software 2 only on computers physically located at their or business offices. Franchisees may install one copy of Software 1 and Software 2 on each location's computer system. For , this computer system must consist of one back-of-house server computer and multiple front-of-house work stations designed to collectively service the individual in which the system is located. For business offices, franchisees may install the software on a testing system used to simulate a system.

In exchange, franchisees must pay license fees of Amount 1 per- (i.e. per-site) at which the franchisee installs and uses Software 1 and Software 2. The License Agreement states these fees in a table entitled "Title 1." In a row referring to Software 1, a column entitled "License Fee" states "Amount 1/site." Similarly, in a row referring to Software 2, this column states "[i]ncluded in Software 1 License Fee."¹

The License Agreement provides that Taxpayer may periodically increase the license fee as a result of changing market conditions. These changes allow Taxpayer to pass the cost of these conditions to the franchisee.

Generally, Taxpayer does not separately offer for license or market Software 1 or Software 2 to customers. Rather, Taxpayer licenses Software 1 and Software 2 only incident to its agreements with franchisees to operate Subsidiary-branded

The Franchise Agreement essentially grants franchisees the rights to operate a franchised (collectively, *Franchise Rights*). The Franchise Agreement offers franchisees the right, license, and privilege to use Taxpayer's "operating system", which is defined as "designs, decor [sic] and color schemes for premises, signs, equipment, procedures and formulae for preparing food and beverage products, specifications for certain food and beverage products, inventory methods, operating methods, financial control concepts, training facilities and teaching techniques" and "to use Taxpayer's trademarks, and to hold itself out as a franchisee". In exchange, the Franchise Agreement requires franchisees to pay Amount 3 of gross-sales royalty to Taxpayer every month.

¹ Franchisees must also pay other fees for services related to the Software 1 and the Software 2.

First, franchisees must pay maintenance fees of Amount 2 per-year. The License Agreement states these fees in the table entitled "Title 1." In a row referring to the Software 1, a column entitled "Maintenance Fee" states "Amount 2/site/year. Provides access to periodic software upgrades." Similarly, in a row referring to the Software 2, this column states "[i]ncluded in Software 1 Maintenance Fee . . . [p]rovides access to periodic software upgrades."

Second, franchisees must pay subscription fees for the use of a *switch provider*, a company that facilitates credit or gift card payments. The provider receives transaction data from the Software 2 when a customer swipes a credit or gift card, determines the destination for that data, reformats the data for that destination's receipt, and sends the data to the destination for processing. The provider then returns data from the recipient to the Software 2 to complete the transaction. A switch provider is needed as the Software 2 is not designed to communicate directly with credit and gift card processors.

Starting in 2007, these fees are Amount 4 per-site, per-year; plus additional fees depending on which switch provider the franchisee uses. These fees are described in a table separate from that describing the license fees described above.

Third, franchisees must pay *on-boarding fees* for training and installation. The License Agreement describes these fees as for "services for [the Software 1] that will provide the process and procedures for successful launch of the [Software 1] product by [the franchisee's] team." These fees are equal to the cost of travel and expenses for Taxpayer's on-boarding personnel assigned to the franchisee. These fees are described in a table separate from that describing the license fees discussed above.

In Tax Year Ending 1, Tax Year Ending 2, and Tax Year Ending 3, Taxpayer claims it is entitled to deductions under I.R.C. § 199(a). See I.R.C. § 199(a)(1) (repealed 2017) (providing that a taxpayer may deduct a fraction of the excess of his qualified production activities income (*QPAI*) or taxable income); I.R.C. § 199(c)(1) (defining *QPAI* as the excess of a taxpayer's *DPGR* over expenses allocable to such receipts). Taxpayer claims it derived *DPGR* from licensing computer software it manufactured, produced, grew or extracted (*MPGE*) in significant part within the United States. See I.R.C. § 199(c)(4)(A)(i)(I) (defining *DPGR* as including the gross receipts of the taxpayer which are derived from any lease, rental, license, sale, exchange, or other disposition of *QPP* which was *MPGE* by the taxpayer in whole or in significant part within the United States); I.R.C. § 199(c)(5)(B) (defining *QPP* as including any computer software).

Taxpayer allocates these gross receipts according to a transfer pricing analysis that estimates the portion of its gross receipts attributable to its computer software. This analysis involves allocating gross receipts to Taxpayer's alleged economic-value drivers based on several kinds of comparisons to allegedly similar firms in allegedly similar industries. The transfer pricing analysis effectively allocates a portion of the Amount 3 royalty payments to *DPGR* derived from the disposition of computer software. Consequently, Taxpayer's allocation of receipts to the disposition of computer software to *DPGR* is greater than Amount 1, which the franchisees pay to Taxpayer pursuant to the License Agreement. Taxpayer has not increased Amount 1 for many years and argues that its agreements' terms are outdated and undercharge for the license of Software 1 and Software 2.

Taxpayer does not use the allocations for internal management purposes, other business purposes, Federal income tax purposes, or state income tax purposes. Taxpayer uses the transfer pricing amounts only for its section 199 claims. Taxpayer uses the amounts stated on its agreements for all other purposes. Its internal records, financial statements, Federal tax returns, and State tax returns all reflect that Taxpayer recognized only the Amount 1 fees as gross income from a software license during the year in which the franchisee paid the amount. Taxpayer only developed its method in anticipation of its current section 199 claims and did not use it prior to raising these claims.

LAW AND ANALYSIS

Law—Section 199 and Regulations

I.R.C. § 199(a)² allows taxpayers a domestic production activities deduction (the *DPAD*) equal to nine percent of the lesser of their *qualified production activities income* (QPAI) or their taxable income. Section 199(c)(1) defines QPAI as the excess of the taxpayer's *domestic production gross receipts* (DPGR) for the year over the sum of the cost of goods sold and other expense, losses, and deductions allocable to such receipts. Section 199(c)(4)(A)(i)(I) defines DPGR, in part, as "the gross receipts of a taxpayer which are derived from - (i) any lease, rental, license, sale, exchange, or other disposition of - (I) qualifying production property which was manufactured, produced, grown, or extracted (*MPGE*) by the taxpayer in whole or in significant part within the United States." See also Treas. Reg. § 1.199-3(a). Section 199(c)(5) defines *qualifying production property* (QPP) as including, *inter alia*, "any computer software."

Treas. Reg. § 1.199-1(d)(1) generally provides that a taxpayer must determine the portion of its gross receipts for the taxable year that is DPGR and the portion of its gross receipts that is non-DPGR. Applicable Federal income tax principles apply to determine whether a transaction is in substance a lease, rental, license, sale, exchange, or other disposition the gross receipts of which may constitute DPGR (assuming all the other requirement of § 1.199-3 are met), whether it is a service the gross receipts of which may constitute non-DPGR, or some combination thereof. For example, if a taxpayer leases QPP and in connection with that lease, also provides services, the taxpayer must allocate its gross receipts from the transaction using any reasonable method that is satisfactory to the Secretary based on all the facts and circumstances and that accurately identifies the gross receipts that constitute DPGR and non-DPGR.

Treas. Reg. § 1.199-1(d)(2) provides that factors taken into consideration in determining whether the taxpayer's method of allocating gross receipts between DPGR and non-DPGR is reasonable include whether the taxpayer uses the most accurate information available; the relationship between the gross receipts and the method used; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the taxpayer for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the time, burden, and cost of using alternative methods; and whether the taxpayer applies the method consistently from year to year. Thus, if a taxpayer has the information readily available and can, without undue burden or expense, specifically identify whether the gross receipts derived from an item are DPGR, then the taxpayer must use that specific identification to determine DPGR. If a taxpayer does not have information readily available to specifically whether the gross receipts derived from an item are DPGR, then the taxpayer is not required to use a method that specifically identifies whether the gross receipts derived from an item are DPGR.

² Except as otherwise noted, all section references herein are to the Internal Revenue Code as in effect for the year in issue.

Treas. Reg. § 199-3(i)(4)(i)(A) generally provides that gross receipts derived from the performance of services do not qualify as DPGR. In the case of an embedded service, that is a service the price of which, in the normal course of the taxpayer's business, is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition (collectively a *disposition*) of QPP, DPGR include only the gross receipts derived from the disposition of QPP (assuming all the other requirements of § 1.199-3 are met) and not any receipts are attributable to the embedded service. In addition DPGR does not include the gross receipts derived from the disposition of property that does not meet all of the requirements under Treas. Reg. § 1.199-3 (i.e., non-qualified property). The allocation of the gross receipts attributable to the embedded services or non-qualified property will be deemed to be reasonable if the allocation reflects the fair market value of the embedded services or nonqualified property.

Treas. Reg. § 1.199-3(i)(4)(iii), Example 1 provides: X MPGE QPP within the United States. As part of the sale of the QPP to Z, X trains Z's employees on how to use and operate the QPP. No other services or property are provided to Z in connection with the sale of the QPP to Z. In the normal course of X's business, the QPP and training services are separately stated in the sales contract. Because, in the normal course of X's business, the training services are separately stated, the training services are not treated as embedded services under the de minimis exceptions in paragraph (i)(4)(i)(B)(6).

Treas. Reg. § 1.199-3(i)(4)(iii), Example 2 provides: the facts are the same as in Example 1 except that, in the normal course of X's business, the training services are not separately stated in the sales contract and the customer cannot purchase the QPP without the training services. If the gross receipts for the embedded training services are less than 5% of the gross receipts derived from the sale of X's QPP to Z, after applying the exceptions under paragraph (i)(4)(i)(B)(1) through (5) of this section, then the gross receipts may be included in DPGR under the de minimis exception in paragraph (i)(4)(i)(B)(6) of this section.

Issue 1: Whether Taxpayer must use its agreements' separately stated prices to allocate gross receipts between DPGR and non-DPGR under Treas. Reg. § 1.199-1(d)(1) and (2)?

Taxpayer must allocate its gross receipts received under its License and Franchisee agreements between those that are DPGR and those that are non-DPGR. See Treas. Reg. § 1.199-1(d)(1). Taxpayer allocates these gross receipts according to a transfer pricing analysis that estimates the portion of its gross receipts attributable to its computer software. This analysis involves allocating gross receipts to Taxpayer's alleged economic-value drivers based on several kinds of comparisons to allegedly similar firms in allegedly similar industries.

Taxpayer cannot allocate its gross receipts this way, because this method is unreasonable and does not accurately identify the gross receipts that constitute DPGR. See Treas. Reg. § 1.199-1(d)(1). This method is unreasonable because Taxpayer has information readily available and, using this information, Taxpayer can specifically identify if the gross receipts derived from its transactions are DPGR. See Treas. Reg. § 1.199-1(d)(2). This readily available information is Taxpayer's agreements' literal terms. In other words, Taxpayer's License Agreements separately state a price for its computer software. Consequently, Taxpayer must use this separately stated price to allocate gross receipts between DPGR and non-DPGR. See Treas. Reg. § 1.199-1(d)(2), which includes the following factors as relevant to determining if an allocation method is reasonable:

1. Whether the taxpayer uses the most accurate information available;
2. The relationship between the gross receipts and the method used;
3. The accuracy of the method chosen as compared with other possible methods;
4. Whether the method is used by the taxpayer for internal management or other business purposes;
5. Whether the method is used for other Federal or state income tax purposes;
6. The time, burden, and cost of using alternative methods; and
7. Whether the taxpayer applies the method consistently from year to year.

Thus, if Taxpayer has the information readily available and can, without undue burden or expense, specifically identify whether the gross receipts derived from its computer software are DPGR, then the taxpayer must use that specific identification to determine DPGR. Id. The factors relevant to the analysis of Taxpayer's allocation are:

Factor 1. Taxpayer does not use the most accurate information available. Taxpayer uses a complex transfer pricing analysis to *estimate* what amount franchisees should have paid for Taxpayer's computer software. Rather, its agreements state what amounts franchisees *actually* paid for Taxpayer's computer software. The License Agreement specifically states that a franchisee must pay Amount 1 per- to install and use Software 1 and Software 2.

Factor 2. Taxpayer's method has a weak relationship with the gross receipts at issue. Taxpayer estimates the gross receipts based on a multi-step comparison of several alleged economic-value drivers and multiple comparisons with allegedly comparable firms. In contrast, its agreements identify the specific gross receipts franchisees must pay for the specific properties offered in the agreements. Taxpayer's allocation of receipts to the disposition of computer software to DPGR is greater than Amount 1, which the franchisees actually pay to Taxpayer pursuant to the License Agreement.

Factor 3. Taxpayer's method is inaccurate as compared to allocating based on the separately stated prices in the License Agreement. Taxpayer's method produces an estimate. Its agreements state the specific amount actually paid to Taxpayer by unrelated customers in an arms-length transaction.

Factors 4 and 5. Taxpayer does not use its estimates for internal management purposes, other business purposes, Federal income tax purposes, or state income tax purposes. Taxpayer uses its estimates only for its section 199 claims. Taxpayer uses the amounts stated on its agreements for all other purposes. Its internal records, financial statements, Federal tax returns, and State tax returns all reflect that Taxpayer recognized Amount 1 in gross income per-site during the year in which the franchisee paid the amount.

Factor 6. Taxpayer's method requires more time, burden, and cost than following its agreements would. Taxpayer's method requires Taxpayer to conduct extensive transfer pricing analyses, collect information about allegedly comparable transactions and firms, and employ transfer pricing specialists. In contrast, Taxpayer has already collected and tracked the information needed from its agreements and its franchisees' payments under those agreements.

Factor 7. Taxpayer does not apply its method consistently from year to year. Taxpayer only developed its method in anticipation of its current section 199 claims and did not use it prior to raising these claims. Taxpayer has been using the actual amounts paid under its agreements since before it raised its section 199 claims and continues to use this method for all non-section 199 purposes.

Considering the seven factors listed in Treas. Reg. § 1.199-3(d)(2), Taxpayer has information readily available and can, without undue burden or expense, specifically identify whether the gross receipts derived from an item are DPGR. Taxpayer must use its readily available information, its agreements separately stated prices, to determine DPGR. Taxpayer's method is unreasonable based on all the facts and circumstances and does not accurately identify the gross receipts that constitute DPGR. See Treas. Reg. § 1.199-1(d)(1).

Issue 2: Whether Taxpayer can allocate separately stated gross receipts for intangible property as attributable to an embedded service or nonqualified property under Treas. Reg. § 1.199-3(i)(4)(i)(A) when the regulation requires a taxpayer to allocate gross receipts between embedded non-qualified property and QPP?

In the normal course of Taxpayer's business, the Amount 3 royalty price for the Franchise Rights is separately stated from the Amount 1 price for the software license. Taxpayer appears to argue that the Franchise Rights are embedded in its disposition of computer software. See Treas. Reg. § 1.199-3(i)(4)(i)(A). Consequently, Taxpayer argues that it must allocate its gross receipts from the embedded disposition of its Franchise Rights and computer software according to what Taxpayer states is the computer software's fair-market value, rather than the actual amount paid based on Treas. Reg. § 1.199-3(i)(4)(i)(A). In other words, Taxpayer attempts to allocate non-DPGR gross receipts from the royalty payment received for its Franchise Rights to DPGR from its license of computer software.

Taxpayer's Franchise Rights are not embedded in its disposition of computer software. As stated above, Taxpayer's agreements separately state and include information readily available that specifically identifies the gross receipts from the disposition. See Treas. Reg. § 1.199-3(i)(4)(i)(A). Thus, Taxpayer's Franchise Rights are not embedded in its disposition of computer software. The Examples also make clear that separately stated items are not treated as embedded services. Example 1 of Treas. Reg. § 1.199-3(i)(4)(iii) provides that training services are not embedded in the disposition of related QPP if the taxpayer's sales contracts separately states prices for the services and QPP. Compare with Example 2 of Treas. Reg. § 1.199-3(i)(4)(iii), which provides that training services are embedded in the disposition of related QPP if the taxpayer's sales contracts do not separately state prices for the services and QPP.

Based on the above, Taxpayer may not allocate gross receipts from the transaction between these two properties based on an argument under Treas. Reg. § 1.199-3(i)(4)(i)(A). Taxpayer's agreements state separate prices for each property. The intangible rights are not embedded with the QPP.

Issue 3: Whether Taxpayer may disregard its agreements' terms and allocate gross receipts received for a grant of intangible rights to a license of QPP?

Taxpayer argues that it may disregard its agreements' form, their terms, and the amounts paid under the Franchise Agreement and License Agreement. Taxpayer bases its argument on the fact that it has not increased Amount 1 for many years and argues that its agreements' terms are outdated and undercharge for the license of Software 1 and Software 2.

Nevertheless, Taxpayer may not disregard its agreements' form, their terms, the amounts paid, or their tax consequences. Taxpayers generally must accept the tax consequences of their transactions' form. See Commissioner v. Nat'l. Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) ("[W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not.") (Internal citations omitted).

Taxpayer chose to structure its transaction as it did, to phrase its agreements as it did, to charge the amounts stated in its agreements, and to not modify the agreements. Taxpayer could have structured its transactions differently. It could have worded its agreements differently. Taxpayer could have increased the license fee as a result of changing market conditions to pass the cost of these conditions to the franchisee as set forth in the License Agreement, but Taxpayer did not. Therefore, Taxpayer may not disregard its Franchise Agreement, License Agreement, and the actual amounts paid pursuant to those agreements for the Franchise Rights and computer software to increase its DPAD deduction under section 199.

Please call (213) 372-4071 if you have any further questions.

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